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SUBJECT: KAZAKHSTAN: NATIONAL OIL FUND MECHANISM CHANGED

¶1. (SBU) Summary: In July 2006, the government of Kazakhstan implemented a new mechanism governing contributions to the National Fund, altering the rules for state use of oil revenues. Under the new mechanism, all oil-sector revenues are steered directly to the National Fund and invested abroad, with the budget receiving back a legislated amount earmarked for "development projects." Non-development expenditures, meanwhile, are to be funded exclusively via the "non-oil budget." The new mechanism reinforces the GOK's overall objective of stimulating diversification. In implementing the new mechanism, the GOK followed World Bank recommendations closely, and appears to have taken another solid step in legislating prudent spending limits and responsible management of Kazakhstan's oil revenues. End summary.

Background

¶2. (U) The GOK established the National Fund by presidential decree in August 2000. The National Fund, invested entirely abroad, was designed both to save oil revenues for future generations and to reduce the national budget's dependence on world commodity prices and the economy's vulnerability to inflationary pressures caused by inflows of excess petrodollars. As of September 2006, the National Fund had accumulated $11.8 billion, achieving an average annualized return of just over 5%.

Old Mechanism: Oil in Economy's Veins

¶3. (U) The "old system" functioned by accumulating in the National Fund all marginal state revenue generated from oil enterprises when oil prices exceeded $19/barrel. Revenues from the first $19/barrel entered the national budget. Criticism of the "old" mechanism focused on three primary weaknesses: (a) the definition of "oil enterprise" was non-inclusive and frequently changed; (b) successful application of the formula - and hence budgetary planning - depended on a complicated estimation of anticipated oil revenues; and (c) the old concept allowed the government to simultaneously contribute to the NF and issue new debt, thus undermining the sense in which contributions to the NF represented "net savings." (The presidential decree establishing the new mechanism emphasizes another flaw in the "old mechanism" - the fact that government oil revenue is dependent on the concept of taxable income, and thus on various accounting tactics which vary greatly from year-to-year.)

¶4. (SBU) There is indirect empirical support for the notion that the old mechanism was a faulty safety valve for limiting the flow of NF money into the national budget. Although the GOK does not currently provide budget data differentiating its oil revenues from non-oil revenues, there is evidence that the government's 2005 spending splurge in the run-up to the presidential election was largely fueled by oil revenue. According to official statistics, the overall budget revenues (national and local) grew from 22.2% of the GDP in 2004 to 28.2% in 2005, a radical rise that can not be explained by increases in non-oil revenue. The year offered plenty of other economic signs of more petrodollars finding their way into

the economy: rapidly rising money supply (48% growth from January to September 2006), inflationary pressures (evident as inflation ticked up from 7.5% in December 2005 to 8.7% in August 2006), and the steeply appreciating tenge (rising 12.9% against the dollar and 8.3% against the euro in the year ending July 2006).

The New Mechanism: Fiscal Discipline in the Air
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¶5. (U) The new mechanism transfers all oil revenues directly to the National Fund. A defined quantity, established by a formula with legislatively set variables, is then transferred back to the budget every year. This amount is restricted to funding "development programs." This implies that general government expenditures are financed solely by non-oil revenues. This, according to the government's plan, is an important limitation on spending as well as an incentive for developing the non-oil sector, since general government expenditures can only be increased by boosting budgetary revenues from the non-oil sector. The new NF mechanism thus reinforces the general GOK ambition to diversify the economy away from hydrocarbons.

¶6. (U) The new mechanism contains features designed to address the criticisms levied against the "old" system. For example, the definition of "oil revenues" is made broader and more explicit. (Comment: A logical next step in protecting the national budget from fluctuations in commodity prices might be to include in the National Fund government revenues from other important commodities such as copper. End comment.) Furthermore, the guaranteed transfer from the NF in any given year is subject to a ceiling of one-third of the National Fund's total assets. Most importantly, perhaps, the new mechanism introduces a "budget deficit limitation," which sets the maximum level of government borrowing to finance the overall budget deficit at 1% of the GDP (measured as the annual average value over

a 5-year period); this is meant to prevent the government from engaging in a borrowing binge while ostensibly stashing oil revenues into the NF.

¶7. (SBU) The new mechanism was designed with significant input from the World Bank, and, predictably, local World Bank representative Loup Brefort lauded the mechanism, telling Econoff that the GOK had essentially adopted the World Bank's recommendations. However, Brefort downplayed the importance of limiting NF spending to "development programs." The fungibility of money, he said, negated much of the distinction's efficacy.

The Tenge Connection?

¶8. (SBU) Some observers believe that the recent reversal in the long-standing trend of tenge appreciation is a result of the new mechanism, which serves to ease upward pressure on the domestic currency by investing more of the government's petrodollars abroad. (Note: after peaking against the dollar at 117.25/$1 on July 23 2006, the tenge has retreated to 127.84/$1 as of November 1. End note.) However, another observer, claiming access to inside information, told post that the tenge reversal is a result of the National Bank's current dollar-buying campaign aimed to "flush out offshore speculators" betting on further tenge appreciation.

¶9. (SBU) Comment: The new mechanism represents a clear improvement over its predecessor, and the GOK deserves credit for institutionalizing limits to its own discretionary spending. Having said that, it is difficult to dispute Brefort's caveat that the fungibility of money undercuts the limitation of the use of Fund monies only on "development programs." Ultimately, the effectiveness of the mechanism will depend on the government's commitment to control the non-oil budget deficit and resist the political pressures to legislate parameters which greatly expand the size of the "guaranteed transfer." Given the GOK's ongoing grandiose plans to further develop Astana, create a "financial center" in Almaty, and spur economic diversification through government-financed projects, such pressures are likely. End comment.

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